February 1, 2000

Ms. Gloria Blue
Executive Secretary
Trade Policy Staff Committee
Office of the United States Trade Representative
600 17th Street, N.W.
Washington, D.C. 20508

Re: USTR Section 1377 Request for Comments
Concerning Compliance with Telecommunications Trade Agreements.

Dear Ms. Blue:

On behalf of AT&T Corp. ("AT&T"), I am pleased to respond to the request of the United States Trade Representative ("USTR") for comments pursuant to Section 1377 of the Omnibus Trade and Competitiveness Act of 1988, 19 U.S.C. Section 3107, concerning implementation of the World Trade Organization ("WTO") Basic Telecommunications Agreement.

As described below, AT&T is strongly concerned by the failure of Canada, Mexico, South Africa and Israel to meet their commitments under the WTO General Agreement on Trade in Services (GATS) and the WTO Agreement on Basic Telecommunications and urges USTR to take all necessary action to bring these countries into compliance with their obligations as quickly as possible.

I. CANADA.

While Canada opened its telecommunications market to long distance competition in 1992, and to local service and international long distance competition in 1998, this country has notably failed to establish laws and regulations that allow new entrants to compete with the incumbent former regional monopoly carriers on fair and equal terms. Bell Canada and the other incumbents still control at least 97 percent of all local access lines in Canada and have approximately 65-70 percent of the domestic long-distance market. They undoubtedly qualify as major suppliers under the WTO Reference Paper because they not only have "control over essential facilities" in Canada, but also have the "ability to materially affect the terms of participation" through "use of [their] position in the market." By failing to ensure proper regulation to prevent anticompetitive practices, and by requiring competitive carriers to subsidize the incumbents through overly burdensome universal service contributions, Canada is disadvantaging competitors in a manner contrary to the requirements of the WTO Reference Paper and is thereby encouraging the re-monopolization of its telecommunications industry.

In 1997, five years after opening the domestic long distance market to competition, the Canadian regulator, the CRTC, granted all the former regional monopolies regulatory forbearance in domestic long-distance services, notwithstanding their continued control of bottleneck local termination facilities, their 70 percent share of the domestic long-distance market and "the absence of ubiquitous, competitor-owned transmission facilities across Canada." The forbearance decision ended prior approval requirements for the former regional monopolies' long-distance tariffs and rates and also removed the price floor preventing anticompetitive pricing of their long-distance services. In 1998, the CRTC went even further and allowed the former regional monopolies to bundle their local monopoly services with competitive long-distance services without sufficient safeguards to prevent the cross-subsidization of their competitive services with monopoly revenues.

Since the CRTC's Forbearance and Bundling decisions, the incumbents have offered long-distance rates that allow little, if any, margin when matched by competitive carriers, and consequently the incumbents are now increasing their long-distance market share. Following those decisions, AT&T Canada, the largest competitive carrier in Canada, has exited the residential long-distance business altogether and another major competitor, Sprint Canada, is now facing financial difficulties.

Anticompetitive universal service subsidies: The damage caused to competition in Canada by the CRTC's premature deregulation of the incumbents is exacerbated by the CRTC's continued refusal to change Canada's unfair and anticompetitive "contribution charge" system for universal service support. For the former regional monopolies, Canada's universal service system simply requires the transfer of funds from one part of their operations to the other without any bottom line impact. Competitive long-distance carriers, however, are required to pay a huge, unjustified and increasing subsidy to the former regional monopolies with insufficient safeguards to prevent its use to cross-subsidize the former regional monopolies' competitive services. Also, because the subsidy is levied on long-distance calls on a per minute basis, is unlimited in total amount, and has a disproportionately adverse impact on competitive long-distance carriers, which receive virtually no subsidy payments, it encourages the former regional monopolies to engage in anticompetitive pricing to stimulate increased subsidy payments to themselves and to reduce their long-distance competitors' margins.

Since 1992, Canada has required long distance services to subsidize affordable basic service in high cost areas through contribution charges. Thus, the CRTC reaffirmed in 1997 with the opening of the local market that the "level of contribution should be set to ensure that residence rates in high cost areas continue to permit universality of access, while minimizing distortion of the competitive market." However, Canada's present contribution regime requires competitive carriers to make payments far in excess of this level and thus fails to meet the requirements of the WTO Reference Paper that universal service obligations "will not be regarded as anticompetitive *per se*, <u>provided</u> they are administered in a transparent, non-discriminatory and competitively neutral manner and are not more burdensome than necessary for the kind of universal service defined by the Member." (Emphasis added.) Indeed, Canada's contribution charge regime is contrary to all of the WTO requirements for universal service programs, as it is not only far more burdensome than necessary, but also fails to be transparent, non-discriminatory and competitively neutral.

As a threshold matter, Canada artificially inflates its residence subsidy requirement by calculating this amount through use of incremental ("Phase II") costs plus a 25 percent mark-up, "as a proxy cost" for embedded ("Phase III") costs. The cost of universal service should rather be based on the forward-looking costs, including a reasonable return on investment, that an efficient firm would incur in a competitive market. Moreover, Canada also requires contribution payments well in excess of this inflated residence subsidy requirement as the result of the CRTC's 1997 decision to freeze per minute contribution rates for the period 1998-2001 without any adjustment for the subsequent growth in contribution eligible minutes.

Consequently, the substantial growth in contribution eligible minutes since the introduction of flat-rate long-distance pricing plans in mid-1998 are forecasted by AT&T Canada to produce excess contribution revenues for the former regional monopolies during the 1998-2001 rate freeze period of $CAN 730 million above the $2.6 billion contribution requirement for those years. (As described below, the CRTC estimates excess contribution revenue of $CAN 540 million for the 1999-2001 period.) At the same time, the incumbents have not experienced reductions in the so-called "implicit" universal service subsidies they obtain from profits on optional local services like caller ID and call waiting as the result of competition in local services. Contrary to the expectation of the CRTC, reductions in these implicit subsidies have not materialized because there is relatively little local service competition in Canada.

The CRTC has rejected two appeals against the contribution rate freeze by AT&T Canada. Most recently, on December 15, 1999, the CRTC dismissed AT&T Canada's request for reduced rates to ensure that future contributions would not exceed the contribution requirement established in 1998, because it determined that contribution revenues over the remaining period of the freeze from 1999-2001, which it estimated to be $CAN 2.45 billion, would only be slightly above the level that could reasonably have been expected based on minute growth in prior years. Significantly, the CRTC provided no cost justification showing that $CAN 2.45 billion would be necessary to meet the requirements of its universal service program, although this amount exceeds by $CAN 540 million the contribution requirement for those years based on the level established in 1998 (which is itself unduly inflated because it is based on a cost proxy reflecting embedded rather than incremental cost.) The CRTC December 15 decision also failed to take account of the continued implicit subsidies received by the former regional monopolies from profits on optional local services. Accordingly, because it requires excessive and unlimited payments, Canada's contribution regime is "more burdensome than necessary for the kind of universal service defined by the Member," contrary to the requirements of the WTO Reference Paper.

The contribution regime is also unreasonably burdensome and is not competitively neutral because it causes disproportionate harm to competitive carriers in Canada. The growth in contribution eligible minutes stimulated by lower long-distance prices has a much greater adverse impact on competitive carriers, for whom the growth in fixed amount per minute contribution payments generated by lower-priced long-distance minutes is not matched by growth in long-distance revenue and thus increases their costs. In contrast, the former regional monopolies experience no negative impact on their profitability, because virtually each new dollar of contribution payment incurred by their long-distance services is simply an additional dollar earned by their local services. Therefore, the structure of the contribution regime, together with Canada's ineffective regulation of anticompetitive practices by the former regional monopolies, creates an incentive for the former regional monopolies to price long-distance services below cost, thus stimulating additional traffic and further widening the profitability gap with their competitors.

Canada's present contribution system also harms competition in Canada's local market, where, as with the early stages of U.S. local competition, competitive local exchange carriers are largely focused on local business customers. Because the CRTC's price cap rules prohibit any reductions in rates that are already below cost, which is generally the case with local residential rates in Canada, to the extent increasing contribution payments result in lower local rates in Canada, they are generally used to lower rates to local business customers -- thus impeding local competitive entry.

Inadequate competitive safeguards: Another major concern is the absence of adequate regulatory safeguards in Canada to prevent cross-subsidization by the incumbents. The CRTC has previously recognized that "the telephone companies have both the incentive and the opportunity to use their vertically integrated structures to lessen competition by exploiting control over bottleneck facilities." Yet, unlike the approach taken in the U.S. with the 1984 divestiture of AT&T's former local bottleneck facilities and with statutory requirements for the provision of in-region long-distance services by the Bell Operating Companies through separate affiliates (once they satisfy the local competition requirements of Section 271 of the Telecommunications Act of 1996), Canada has required no divestiture by the former regional monopolies and does not require the provision of competitive services through separate affiliates.

Instead, following the Forbearance decision and the adoption of price-cap regulation, Canada now seeks to prevent the shifting of costs from competitive to monopoly services and other forms of anticompetitive cross-subsidization solely through the tariffing and partial price-cap regulation of local services, the imputation test for bundled services and inadequately policed accounting rules -- which remove neither the incentive nor the ability to misallocate costs, particularly regarding local services not subject to price caps, such as Centrex services. These measures are insufficient to meet the requirements of the WTO Reference Paper for the maintenance of appropriate measures to prevent major suppliers such as the former regional monopolies from "engaging in or continuing anticompetitive practices," and particularly from "engaging in anticompetitive cross-subsidization." Their inadequacy is fully demonstrated by the continuing dominance of Canada's local and long-distance markets by the vertically integrated former regional monopolies, the increasing profitability of these carriers notwithstanding their low prices in the domestic long-distance market, and the losses experienced by their competitors.

In sum, Canada's failure to ensure a level competitive playing field is having a significant, adverse impact on the competitive environment in the Canadian telecommunications industry. Seven years after the introduction of competition in the U.K., U.S., and Canadian telecommunications markets, all of the new competitive carriers in these countries reported similar levels of investment and revenue as a percentage of each market. After that initial seven-year period, competitive carriers in the U.K. and U.S. reported positive net incomes of 2 percent and 16 percent, respectively. The competitive carriers in Canada, however, reported losses of 39 percent. Therefore, USTR should take all necessary action to require Canada to act in compliance with the requirements of the WTO Reference Paper by ceasing the forced subsidization of the incumbents through the contribution regime and adopting the necessary safeguards to prevent the former incumbents from engaging in anticompetitive behavior.

II. MEXICO.

While AT&T greatly appreciates the efforts by USTR to obtain Mexico's compliance with its obligations under the WTO Agreement, the serious nature of the problems described below continues to require the pursuit of all available avenues to obtain their prompt resolution.

International services barriers: Two years after the effective date of the WTO Agreement, Mexico has still failed to implement its WTO commitments requiring the removal of market access barriers supporting the high settlement rates maintained by Telefonos de Mexico ("Telmex"), the former monopolist and the dominant carrier. The inability of U.S. carriers to obtain reasonable termination charges for calls to Mexico has caused significant harm for many years to U.S. consumers. Telmex's present settlement rate with U.S. carriers for international calls of $0.19 remains considerably in excess of the costs Telmex incurs in terminating U.S. traffic, which are below $0.07. Since 1989, Telmex has received more than $6 billion in settlements payments from U.S. carriers.

In today's marketplace, U.S. carriers need to achieve cost-based settlement rates if they are to compete effectively with the dominant foreign carriers that now have access to the U.S. market as the result of the WTO Agreement. Any prospect that the competition resulting from the WTO Agreement will reduce settlement rates to cost-based levels in Mexico, however, is removed by the regulatory barriers that Mexico maintains specifically to protect Telmex's monopoly profits from this result. Thus, Telmex benefits from Mexico's regulatory barriers protecting high termination rates in Mexico, but can provide nationwide resale services in the U.S. through its U.S. affiliate Telmex USA.

Mexico's WTO commitments require the immediate removal of all its existing restrictions on the origination and termination of switched international traffic over international private lines outside the settlement rate and proportionate return system (also known as "international simple resale" or "ISR" services). ISR services are now authorized on twenty-four U.S. international routes accounting for almost half of all U.S. international calling. Mexico's market access barriers on ISR -- specifically, its anticompetitive international traffic regulations and its failure to authorize resale services -- violate its WTO commitments and harm U.S. consumers by denying U.S. carriers the ability to use ISR to avoid Telmex's high settlement rates on calls to Mexico. Further, under Mexico's WTO commitments, AT&T, as a supplier of cross-border voice services to Mexico, is entitled to interconnect these services on non-discriminatory terms and at cost-oriented rates at any technically feasible point in the network of Telmex. Mexico's fulfillment of this obligation would substantially reduce the cost of U.S.-Mexico call termination.

Mexico's continuing market barriers in international services include its regulations requiring uniform accounting rates and proportionate return and prohibiting the negotiation of settlement rates by any carrier other than Telmex. Through these regulations, Mexico prevents competition from AT&T's affiliate Alestra and other competitive facilities-based carriers in Mexico from reducing Telmex's high settlement rates. The OECD underscored the anticompetitive nature of these regulations in an August 1999 report, which found that Mexico's "arrangements for the international exchange of traffic restrict competition" and that "[t]he elimination of this system would lead to immediate price reductions on international calls and benefits to both Mexican and foreign consumers."

Mexico's WTO commitments also require the retrospective removal for 1998 of the discriminatory, non-cost based access charge of 58 percent of the settlement rate on inbound international calls.

Inadequate domestic regulation: Mexico has also failed to establish the level playing field required by its WTO Reference Paper commitments and therefore does not allow the new carriers in Mexico, including AT&T's affiliate Alestra, to compete with Telmex on a fair and equal basis. These carriers are unfairly disadvantaged by the longstanding failure of Cofetel, the Mexican regulator, to ensure that Telmex does not abuse its market power in its dealings with its competitors. Most recently, as described below, Cofetel has done nothing to stop Telmex denying private lines to its competitors for over six months and Cofetel's president has stated that court action by Telmex will prevent Cofetel from undertaking any regulation of Telmex as a dominant carrier. Mexico thus fails to implement and enforce the WTO Reference Paper requirement for safeguards to prevent anti-competitive practices.

Competitive safeguards: The absence of the competitive safeguards required by the WTO Reference Paper is demonstrated by Cofetel's failure to require Telmex to provision private lines to its competitors. Since July 1989, Telmex has refused to provide any new private lines to AT&T's affiliate Alestra and MCI's affiliate Avantel in breach of Mexico's Federal Telecommunications Law, Federal Economic Competition Law and Telmex's Concession. Although Alestra and Avantel filed complaints with Cofetel and the Federal Competition Commission on August 19, 1999, those bodies have not required Telmex to comply with its obligations and immediately to cease this clear abuse of its market power. In addition to adversely affecting the domestic services of its competitors, Telmex's action has directly impacted international private line services that AT&T has sought to provision with Alestra. AT&T has been forced to order these facilities not from Alestra but from Telmex, which has continued to fulfil its own orders while refusing those placed by its competitors. Following the admission to the FCC by Telmex's U.S. subsidiary, Telmex USA, that Telmex has ceased providing new private lines to Alestra and Avantel, the FCC has issued a Notice of Apparent Liability against Telmex USA for these "willful or repeated" violations of the terms and conditions of its FCC authorizations "to the disadvantage of U.S. carriers and consumers."

Mexico's failure to take necessary and timely measures to prevent anticompetitive conduct by Telmex is further demonstrated by the competitive carriers' fruitless efforts to obtain regulation of Telmex as a dominant carrier. The Federal Competition Commission ("CFC") in Mexico has now twice found Telmex to be a dominant carrier and to possess market power in five relevant markets, comprising international long-distance, domestic long-distance, basic local services, access (interconnection) and interurban transport, but has taken no further action because of appeals by Telmex in the Mexican courts. Most recently, the president of Cofetel has stated that Cofetel is unable to issue dominant carrier rules because of a Mexican court ruling in favor of Telmex on grounds of possible constitutional deficiencies in Mexico's competition law -- which does not excuse Mexico from its Reference Paper obligation to maintain competive safeguards to prevent Telmex from abusing its substantial market power.

Interconnection rates: Telmex's competitors are further disadvantaged by the above-cost interconnection rates they must pay Telmex. Domestic interconnection rates in Mexico still remain above-cost, particularly the so-called "off-net" interconnection charges that the competitive carriers pay to terminate their customers' calls outside the areas served by competitive long-distance networks. As highlighted by a 1998 Ovum report, "Telmex does not offer a double transit termination charge service and new entrants are required to resell a long distance service in order to provide national termination." Thus, competitive carriers in Mexico may terminate off-net long-distance calls only by resale of Telmex's long-distance services at retail rates of nearly <u>12 cents</u> per minute plus an interconnection charge. This Telmex nationwide termination charge is more than three times higher than the nationwide rates available in most European countries and well over twice the level of the nationwide wholesale rates that are readily available in the U.S. market.

Other interconnection rates are also unreasonably high. Although Telmex pays only approximately $0.01 per minute for interconnection to competitive local networks in Mexico, competitive carriers must pay Telmex basic interconnection rates of approximately $0.03 per minute for 1999 on an average annual basis, and at higher levels for succeeding years. Cofetel's adoption of these high rates in November 1998 was unsupported by evidence that these higher rates and surcharges are cost-oriented, and even acknowledged that the new rates exceeded the underlying costs of interconnection in order "to maintain an appropriate profitability of [the] local network as a whole."

Subsidizing Telmex in this way cannot be justified as a legitimate universal service subsidy under Mexico's WTO commitments, which require universal service subsidies to be "administered in a transparent, non-discriminatory and competitively neutral manner and [] not more burdensome than necessary for the kind of universal service defined by the Member." Mexico's non-transparent interconnection subsidy of Telmex's local operations meets none of these requirements.

Furthermore, while Telmex's interconnection rates for competitive carriers are raised through annual inflation adjustments, Telmex began offering a discount plan in 1999 that was not registered with Cofetel as required by its regulations and that froze consumer rates, thus squeezing the margins of competitive carriers that seek to match these prices.

Cofetel has also failed to address many complaints filed by Alestra and other competitive carriers concerning anticompetitive conduct by Telmex, including the following:

-- Telmex's practice of charging some of Alestra's customers for a local call whenever they make a long-distance call over Alestra's network. (Cofetel has not replied to Alestra's May 27, 1997 letter raising this concern or to Alestra's May 6, 1998 request for the initiation of administrative proceedings.)

-- Telmex's requirement that Alestra must lease two private lines from Telmex to connect dedicated access customers to its network while Telmex's own dedicated access customers are charged only for one private line. (Cofetel has not replied to Alestra's October 1, 1997 request that Telmex should be required to route direct access traffic to Alestra's customers via Alestra's interconnection links to avoid the need to lease private lines from Telmex.)

-- Telmex's discriminatory treatment of the billing and collection services provided to other concessionaires. (Cofetel has not responded to Alestra's November 4, 1997 request for intervention on this issue, or to the further request for assistance made by several competitive carriers on February 23, 1999.)

Alestra has also been unable to obtain effective action from the Mexican government concerning Telmex's refusal to allow free access to Alestra's 800 numbers from Telmex's public telephones in Mexico. Although Alestra raised this issue with the CFC, Mexico's Federal Competition Commission, on October 8, 1998, Telmex has not been required to cease this anticompetitive practice.

Independent regulator: The continued failure of Cofetel to provide adequate regulation to ensure a level playing field in Mexico's telecommunications market suggests that it lacks the independence and impartiality required by the WTO Reference Paper, which states that "[t]he decisions of and the procedures used by regulators shall be impartial with respect to all market participants." Indeed, the OECD report found last year that "[t]he independence of COFETEL, and the transparency and accountability of its decisions, do not go as far as is desirable. Regulatory independence from day to day political pressures is essential to build confidence of all market participants that government intervention in the telecommunications market will be transparent. Further, independence from the regulated companies is needed to ensure transparent, fair, and reasonably predictable decisions."

III. SOUTH AFRICA.

Telkom, the 70 percent government-owned incumbent monopoly telecommunications operator in South Africa, is engaging in discrimination by refusing to provision new telecommunications facilities to AT&T and many other suppliers of value-added network services (VANS). Telkom commenced this action in September 1999, shortly after the South African regulator, SATRA, directed Telkom on September 10, 1999 "to immediately cease and refrain from . . . [i]ssuing threats to terminate the existing facilities and services of VANS operators." Telkom has challenged SATRA's order in the South African courts, and SATRA has commenced an investigation of Telkom's refusal to provide new facilities.

Nonetheless, Telkom has continued to refuse to provide new facilities to its competitors. VANS suppliers have been unsuccessful in their efforts to obtain interim relief requiring Telkom to continue to provide new facilities to them pending the resolution of these domestic proceedings. As a result, AT&T and many other VANS suppliers in South Africa are unable to obtain the telecommunications facilities they require to serve their customers, although Telkom continues to provide those facilities to its own VANS services.

South Africa's failure to ensure that U.S. VANS suppliers receive the public telecommunications facilities they require to provide VANS services in South Africa, and to prevent Telkom from discriminating against those suppliers in favor of its own competing services, is contrary to its WTO obligations, which include commitments to provide market access and national treatment for VANS services. South Africa is also required under GATS Article VIII to prevent a monopoly supplier such as Telkom from acting in a manner inconsistent with South Africa's obligations or from abusing its monopoly position when competing in the supply of a service outside the scope of its monopoly rights. Moreover, under the WTO Annex on Telecommunications, South Africa is required to ensure that U.S. VANS suppliers receive "access to and use of public telecommunications transport networks and services on reasonable and non-discriminatory terms and conditions."

IV. ISRAEL.

Israel discriminates against international calls to and from the U.S. and Canada by imposing a higher access fee on such calls than on calls to or from all other countries -- without any cost justification for these higher charges. Israel's Ministry of Communications requires calls between Israel and the U.S. and between Israel and Canada to pay access charges of $0.10 in 1998, $0.07 in 1999, $0.05 in 2000 and $0.03 in 2001, while calls between Israel and everywhere else in the world pay access charges of $0.07 in 1998, $0.05 in 1999, $0.03 in 2000 and $0.02 in 2001.

These discriminatory non-cost-oriented access charges are contrary to Israel's obligation under Article II of the GATS to provide most-favored-nation treatment to "services and service suppliers of any other Member." They are also contrary to Israel's WTO Reference Paper obligation to ensure that its major supplier provides non-discriminatory, cost-oriented interconnection for all services -- as demonstrated by the lower access charges applied to non-U.S. and non-Canadian calls, which incur the same origination and termination costs in Israel as calls to and from the U.S. and Canada.

This unjustified discrimination by Israel's domestic access fees for international calls adversely affects U.S. consumers and carriers by inflating artificially the interconnection rates that U.S. carriers are able to negotiate with Israeli carriers for the origination and termination of calls on the U.S.-Israel route.

* * * *

I would be pleased to provide any further information that would be helpful to the Committee.

Respectfully submitted,

[Signed]

Bruce R. Moats
Director - AT&T Federal Government Affairs